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Redesigning Global Finances- The End of Dollar Dominance?

First shy signs of economic recovery suggest that the stimulus packages of the past months have achieved their goal with surprising efficiency. With that, the post-crisis financial reality has begun to materialize. Overhauled regulatory frameworks in the banking sectors of most developed countries will prevent future excesses in that industry and help reduce the likelihood of bubbles caused by previously unregulated assets and asset flows. But another factor accused of contributing substantially to the crisis remains almost unchanged: the global financial architecture, often dubbed Bretton-Woods II.

The US dollar has served as the global reserve currency since the 1944 conference in Bretton Woods, New Hampshire (US). In the 1998 Asian financial crisis, affected states learned the hard way that the only non-conditional insurance against a sudden flight of foreign investors are hard currency reserves, 65 percent of which are currently in dollars. In addition to oil countries saving up petrodollars for times of lower revenues, China's notorious current account surplus has helped it pile up more than $2 trillion in reserves. This tremendous dollar portfolio, some argue, has provided a steady flow of liquidity into the US, holding interest rates low and contributing to the housing market bubble that burst last year.

These flaws are caused not only by Chinese mercantilism and the artificially low yuan exchange rate, but are inherent in the very structure of the global financial architecture, argues Nobel Prize laureate, economist Joseph Stiglitz.

Using the dollar as a global trade and reserve currency means that dollars remain outside of the US. When a national currency functions as an international reserve currency, the issuing country is practically required to run a current account deficit. As a result, in the long run confidence in the dollar might be undermined, reducing the value of dollar reserves. Devaluation can also occur when the issuing country runs a high inflation rate – exactly what China fears will happen in the US when the administration starts the money press to finance the stimulus packages.

Because countries prefer to hold large liquid reserves in dollars to avoid the IMF as a lender of last resort, Stiglitz also identifies huge opportunity costs that burden poor countries. Dollar-denominated reserves yield almost nothing at the low interest rate of the dollar. Money that could be invested in development projects yielding long-term economic development finances American consumption instead. Money needed for development projects must then be borrowed by developing countries at high interest rates, practically amounting to a transfer of wealth from poor to rich nations.

This critical analysis of the single-currency regime is not new, but the crisis has added more fuel to the debate. In March 2009, the People's Bank of China published a call by its governor Zhou Xiaochuan to replace the supremacy of the dollar with the IMF's special drawing rights (SDRs). China's fellow BRIC countries were quick to voice support. The idea of a global reserve currency goes back to John Maynard Keynes' suggestions on how to fight the Great Recession and was already discussed at Bretton Woods.

In such a scenario, the new alternative would not replace local currencies but would allow countries to engage in international trade and keep reserves in a currency that is not subject to the monetary policy of a specific state. The SDRs mentioned by Zhou were introduced by the IMF in 1969 with the intention of creating a supranational reserve currency. Today they are denominated in a basket of major currencies and serve mostly as a currency for payments between the IMF and member countries. In July, the G-20 agreed to have the IMF issue another $250 billion in SDRs, which will be distributed to member countries by quotas based on the size of their economy. Most experts agree that SDRs could theoretically be used for countries to hold reserves, but some warn that it will not change much since SDRs are based on a basket of traditional currencies. In June, IMF First Deputy Managing Director John Lipsky said that it is theoretically possible to delink SDRs from other currencies, turning the IMF into the equivalent of a global reserve bank.

China has also begun to challenge the dollar in its daily business, handing out 650 billion yuan ($95 billion) in loans to friendly nations like Argentina, Malaysia and Indonesia that can be used for purchases in China, thus bypassing the dollar. In the same spirit, some hand-picked Chinese firms received permission to trade in yuan in some neighboring countries. Such moves are reminders of the fact that China wants to be a major player in the global financial game, rather than early signals of the yuan becoming a reserve currency in its own right. Upgrading the yuan to an internationally accepted currency would mean allowing its free exchange against the greenback – and consequently the end of artificial undervaluation and export protection. For now, it seems unlikely that the Chinese would be willing to push their currency so far.

Even if the yuan or any other currency, such as the euro, would be strengthened and could compete with the dollar for supremacy, the UN Expert Commission on Financial Reforms headed by Stiglitz warns that a two-currency system could be even more unstable and inefficient. It has called for the issuing of more SDRs in order to boost confidence in the viability of the IMF's new reserve system. While the IMF has sped up internal reforms and created new tools such as the financial safety net for well-functioning developing countries, a revamp of the reserve system is not foreseeable in the near future. It seems that the relatively quick rebound of the global economy has also closed the window of opportunity to radically redesign the global financial architecture in the interest of more stability and greater global consensus.

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1.1 Resources

1.1.1 Primary Sources

Reform the International Monetary System, by Zhou Xiaochuan, People’s Bank of China
In this document, Zhou Xiaochuan, governor of the People's Bank of China, calls for the creation of “an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run."
SDR Valuation, International Monetary Fund
This website provides SDR valuation, updated daily by the IMF.
The Final Communiqué of the 2009 G-20 Summit in London
From our Primary Resources section, the Final Communiqué of the 2009 London G-20 Summit: The Global Plan for Recovery and Reform
The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System
In this paper the Commission of Experts, headed by Nobel Prize laureate Joseph Stiglitz, criticizes the single currency system and suggests global strategies to fight the crisis.

1.1.2 Research and Academia

International Exchange Rate Systems, by the Kiel Institute
This paper examines institutional arrangements for exchange rate systems. The author discusses the foreign exchange market, different balance of payment situations in which countries find themselves, and the necessary exchange rate adjustments.
A Modest Proposal for International Monetary Reform, by Bruce Greenwald and Joseph E. Stiglitz
This paper argues that the problems described in this newsletter are fundamental aspects of the present system and that, without reform, they will continue to plague the global economy. However, the authors argue that a simple set of institutional reforms would go a long way toward alleviating these difficulties. In order to understand the need for and nature of these reforms, they begin by analyzing the dynamics of the current system using a simple global macroeconomics framework.

1.1.3 Media

Replacing the Dollar with Special Drawing Rights-Will It Work This Time? By Owen F. Humpage
Owen F. Humpage is a senior economic advisor at the US Federal Reserve Bank of Cleveland. His article reviews the history and the current situation of the global currency system, SDRs and the US dollar.
Beijing's Would-Be Houdinis, by Sebastian Mallaby
This article discusses the motivations and implications of Chinese currency policy.
The Next Bretton Woods, by Joseph E. Stiglitz
In this paper Nobel Prize laureate Joseph E Stiglitz argues that the financial crisis was "made in America" and outlines the consequences on developing countries. The economist argues that the costs of further delaying financial reform are tremendous.
A New Bretton Woods? By James M. Boughton

This article examines the history of the international financial system and the summits revolving around it. The author concludes that reforms require both leadership and inclusiveness.

Nongovernmental Organizations

The Bretton Woods Project
The Bretton Woods Project works as a networker, information-provider, media informant and watchdog to scrutinize and influence the World Bank and the IMF. Through briefings, reports and the bimonthly digest Bretton Woods Update , it monitors projects, policy reforms and the overall management of the Bretton Woods institutions with special emphasis on environmental and social concerns.
World Economic Forum
On 15 January 2009, the World Economic Forum released its initial report from the New Financial Architecture project, " The Future of the Global Financial System: A Near-Term Outlook and Long-Term Scenarios ." The effort was mandated by the World Economic Forum's investors and financial services communities in January 2008 to explore the driving forces that are shaping the global financial system and how these forces might affect governance and industry structure.